

**Updated Informative Digest for the State Board of Equalization's
Adoption of Proposed Amendments to California Code of Regulations,
Title 18, Section 1603, *Taxable Sales of Food Products***

The State Board of Equalization (Board) held a public hearing regarding the proposed amendments to California Code of Regulations, title 18, section (Regulation) 1603, *Taxable Sales of Food Products*, on August 5, 2014. During the public hearing, the Board unanimously voted to adopt the proposed amendments to Regulation 1603 without making any changes.

The Board did not receive any written comments regarding the proposed regulatory action and no interested parties appeared at the public hearing on August 5, 2014, to comment on the proposed regulatory action. There have not been any changes to the applicable laws or the effect of, the objective of, and anticipated benefits from the adoption of the proposed amendments to Regulation 1603 described in the informative digest included in the notice of proposed regulatory action. The informative digest included in the notice of proposed regulatory action provides:

Summary of Existing Laws and Regulations

California imposes sales tax on retailers for the privilege of selling tangible personal property at retail. (RTC, § 6051.) Unless an exemption or exclusion applies, the tax is measured by a retailer's gross receipts from the retail sale of tangible personal property in California. (RTC, §§ 6012, 6051.) The term "gross receipts" means the total amount of the sale price without any deduction for the cost of materials used, labor or service costs, interest paid, losses, or any other expense. (RTC, § 6012, subd. (a)(2).) Gross receipts include any services that are part of the sale and all receipts, cash, credits, and property of any kind. (RTC, § 6012.) Although sales tax is imposed on retailers, retailers may collect sales tax reimbursement from their customers. (Civ. Code, § 1656.1; Cal. Code Regs., tit. 18, § 1700, subd. (a)(1).)

Sales of food products for human consumption are generally exempt from tax. However, this exemption does not apply to sales of food products furnished, prepared, or served for consumption at tables, chairs, or counters or from trays, glasses, dishes, or other tableware whether provided by the retailer or by a person with whom the retailer contracts to furnish, prepare, or serve food products to others, or to sales of food products served as meals on or off the premises of the retailer. (RTC, § 6359.) Therefore, issues arise as to whether payments designated as tips, gratuities, and service charges that are related to the taxable sale of food products are includible in retailers' gross receipts.

Under Regulation 1603, subdivision (g), optional payments designated as tips, gratuities, and service charges are not subject to tax (and not included in a retailer's gross receipts); however, mandatory payments designated as tips, gratuities, and service charges are included in gross receipts subject to tax, even if the amount is subsequently paid by the retailer to the server.

On June 25, 2012, the Internal Revenue Service published Internal Revenue Bulletin No. 2012-26, which includes Revenue Ruling 2012-18. This revenue ruling clarified and updated guidelines on taxes imposed on tips under the Federal Insurance Contributions Act, including information on the difference between tips (tip wages) and service charges (non-tip wages). The ruling reaffirmed prior guidance which provided that the absence of any of the following four factors creates a doubt as to whether a payment is a tip and indicates that the payment may be a service charge: 1. The payment must be made free from compulsion; 2. The customer must have the unrestricted right to determine the amount; 3. The payment should not be the subject of negotiation or dictated by employer policy; 4. Generally, the customer has the right to determine who receives the payment.

Effect, Objective, and Benefits of the Proposed Amendments to Regulation 1603

Although Regulation 1603, subdivision (g), was amended in 2007 to clarify the application of tax to tips, gratuities and service charges, it has become evident to Board staff that some retailers are having compliance issues because there is still some remaining confusion regarding what constitutes "mandatory" versus "optional" tips, gratuities, and service charges. The proposed amendments to Regulation 1603 are intended to have the effect and accomplish the objective of addressing these retailers' compliance issues by establishing a bright-line approach to how to treat amounts added by retailers to customers' bills that is consistent with how the retailers treated the amounts for Internal Revenue Service purposes. This new approach will ease compliance for retailers by making it clear that the application of sales tax to the transactions at issue is consistent with federal tax reporting requirements.

Interested Parties Process

Originally, the Board's Business Taxes Committee (BTC) staff prepared draft amendments to subdivision (g) of Regulation 1603 to address the retailers' compliance issues. The draft amendments suggested adding provisions to the regulation explaining that when a retailer keeps records consistent with reporting amounts as tip wages for Internal Revenue Service purposes, such amounts are presumed to be optional and not subject to tax. The draft amendments also provided that a payment of a

tip, gratuity, or service charge is deemed to be mandatory if the amounts are required to be reported, for the purposes of income tax to the Internal Revenue Service, as non-tip wages, and the amendments listed the four factors from Revenue Ruling 2012-18 that the Internal Revenue Service examines to determine if a payment is a tip or service charge (non-tip wage). The draft amendments also clarified subdivision (g)'s existing language and deleted provisions of subdivision (g) that had caused confusion to retailers and staff. The draft amendments also made non-substantive changes to the regulation by updating cross-references and making strictly grammatical changes throughout the regulation. The draft amendments also updated the cross-reference to other regulations following the regulations authority and reference note. Additionally, the draft amendments moved the note section to a point preceding the appendix to the regulation.

BTC staff subsequently provided its draft amendments to Regulation 1603 to the interested parties and conducted an interested parties meeting in December 2013, to discuss the draft amendments. During the December 2013 meeting, interested parties appeared open to staff's proposal and there was a general consensus that creating a bright-line approach with respect to tips, gratuities, and service charges would be helpful to the restaurant industry and staff. Also, participants discussed the effect of the presumption and asked BTC staff what would happen if a retailer did not maintain records for purposes of its federal income tax reporting.

Subsequent to the December 2013 interested parties meeting, staff received letters from Kara Bush on behalf of the California Restaurant Association and from James Dumler of McClellan Davis, LLC. Both letters were dated January 10, 2014. In the first letter, Ms. Bush expressed the California Restaurant Association's appreciation of the Board's efforts to clarify this issue and that the association looks forward to continuing to work with staff and other interested parties to develop a bright-line approach that will foster reporting compliance and audit efficiency. Ms. Bush also expressed appreciation for staff's suggestions and stated that the association will continue to explore other alternatives. In the second letter, Mr. Dumler reiterated concerns expressed during the interested parties meeting that a taxpayer that lacks support for the IRS tip designations would not benefit from the proposed presumption and optional gratuities could incorrectly be presumed to be mandatory. Mr. Dumler also recommended that the examples in the current regulation with respect to mandatory payments be retained.

In response to the concerns expressed at the December 2013 interested parties meeting, staff added language to its draft amendments clarifying the application of the new presumption regarding federal tax reporting and also added provisions to determine whether a payment is "optional" or

“mandatory” when a retailer does not maintain records for purposes of reporting tips to the IRS. When a retailer does not maintain these records, the determination of whether or not the payments are mandatory is consistent with the provisions currently in Regulation 1603, subdivision (g). Additionally, staff added clarifying language to its draft amendments to define the term “amount” as a payment designated as a tip, gratuity, or service charge, or any other separately stated payment for services associated with the purchase of meals, food, or drinks. This amendment was made to reduce historical confusion associated with the use of the word “amount” to refer to payments throughout subdivision (g). Also, due to perceived confusion with staff applying the four factors from Revenue Ruling 2012-18 (referred to above), these factors were deleted from staff’s draft amendments.

In February 2014, staff again met with interested parties to discuss the draft amendments. Staff and interested parties discussed how to make it clear that the draft amendments are only to apply prospectively.

Following the February 2014, interested parties meeting, staff received a letter from Mr. Matt Sutton, sent on behalf of the California Restaurant Association. In his March 6, 2014, letter, Mr. Sutton explained that while the California Restaurant Association has historically disagreed with the taxation of mandatory gratuities, it was appreciative of staff’s ideas and acknowledged that the suggestions for a “bright line” approach, discussed in the discussion papers and both interested parties meetings, have merit. Mr. Sutton further stated that it remains to be seen how the industry will respond to the Internal Revenue Service guidance and how that will interplay with the Board’s practice of taxing mandatory tips.

May 22, 2014, BTC Meeting

Staff made changes to its draft amendments to Regulation 1603 in response to the discussion of the prospective application of the draft amendments at the February 2014 interested parties meeting. Staff changed the draft amendments so that subdivision (g) of Regulation 1603 continues to apply to transactions prior to January 1, 2015, and new subdivision (h), containing what had previously been staff’s draft amendments to subdivision (g), will apply to transactions on and after January 1, 2015. Staff also changed the draft amendments in order to renumber the subdivisions of the regulation following new subdivision (h), and update the regulation’s cross-reference to the renumbered subdivisions.

Subsequently, BTC staff prepared Formal Issue Paper 14-003 and distributed it to the Board Members for consideration at the Board’s May 22, 2014, BTC meeting. Formal Issue Paper 14-003 recommended

that the Board propose to add new subdivision (h) to Regulation 1603 to define the term “amount,” and provide that, for sales made on and after [January¹] 1, 2015, when a retailer keeps records consistent with reporting amounts as tip wages for Internal Revenue Service purposes, such amounts are presumed to be optional and not subject to tax. Additionally, new subdivision (h) provides that when a retailer’s records reflect that amounts are required to be reported to the Internal Revenue Service as non-tip wages, the amount is deemed to be mandatory. Finally, new subdivision (h) provides that when a retailer does not maintain records for purposes of reporting amounts to the Internal Revenue Service, the application of tax to the amounts will be consistent with the provisions currently in Regulation 1603, subdivision (g). The formal issue paper also recommended making non-substantive amendments to the regulation.

The Board discussed Formal Issue Paper 14-003 during its May 22, 2014, BTC meeting. Mr. Matt Sutton appeared on behalf of the California Restaurant Association and made statements similar to those in his March 6, 2014, letter. At the conclusion of the discussion, the Board Members voted 4-0 to propose the amendments to Regulation 1603 recommended in the formal issue paper, subject to conforming to the official text of the regulation at the time of publication. The Board determined that the proposed amendments to Regulation 1603 are necessary to have the effect and accomplish the objective of addressing retailers’ compliance issues by establishing a bright-line approach to how to treat amounts added by retailers to customers’ bills that is consistent with how the retailers treated the amounts for Internal Revenue Service purposes.

The Board also anticipates that the proposed amendments to Regulation 1603 will promote fairness and benefit retailers, Board staff, and the Board by providing regulatory provisions that may be applied using a bright-line approach that is consistent with federal tax reporting requirements on these transactions, and thereby reduce confusion for retailers and staff.

The Board has performed an evaluation of whether the proposed amendments to Regulation 1603 are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because there are no other sales and use tax regulations that specifically apply to restaurants’ and similar establishments’ collection of amounts as tips, gratuities, and service charges. In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1603 or the proposed amendments to Regulation 1603.

¹ The informative digest in the notice of proposed regulatory action contained a typographical error indicating the month of July instead of January.